

The Credit Index Call

Taking a View on Jump - Buy HY10 7yr 15-25% protection versus Sell 25-35%



Commentary and Trade Ideas on Index Options and Tranches

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Market Outlook

If asked about the current state of the market, we would highlight three main features. First, extreme market volatility, which is unlikely to subside until European policymakers come up with a solid solution to restore confidence. Second, reduced dealer risk appetite combined with regulatory uncertainty over market making (notably the proposed Volcker rules) to keep secondary liquidity low. Third, a substantial pick-up in jump risk coinciding with a spate of defaults should pressure short-dated protection for some of the names widely expected to default.

The market tone has started to change this week, credit indexes have bounced off the upper ends (see left chart) of trading ranges and we could have further spread tightening before the year ends. Separately, it is worth highlighting the recent underperformance of MCDX, which came close to the wides reached earlier this year at the peak of the muni crisis (see right chart). We think that the underperformance of MCDX is mainly attributed to technicals: trade unwinds in a poor liquidity environment. When technicals start to abate, in our view, MCDX spreads should catch up to credit indexes,

CDX IG versus iTraxx

MCDX versus CDX IG

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CREDIT

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Recent Research

Credit Strategy Presentations'- Are corporates the new safe haven?

30 Nov: European credit outlook 2012

Global Structured Credit Strategy

10 Nov: CLO Calls, CLO Equity Q3, More Insurance Investors in CLOs

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18 Nov: CDX9 Equity Steepener: Default Protection plus Roll-down

European Credit Weekly

2 Nov: Accelerating the Endgame

Credit Strategy Presentations - Structured credit outlook

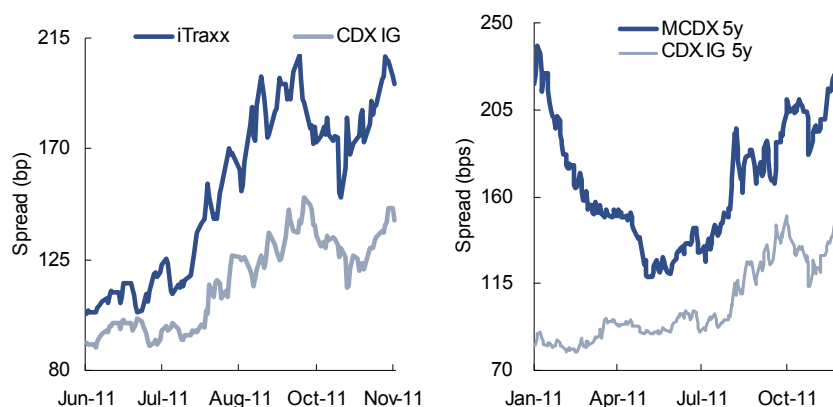
30 Nov: Apocalypse yesterday

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23 Nov: No news, no skews

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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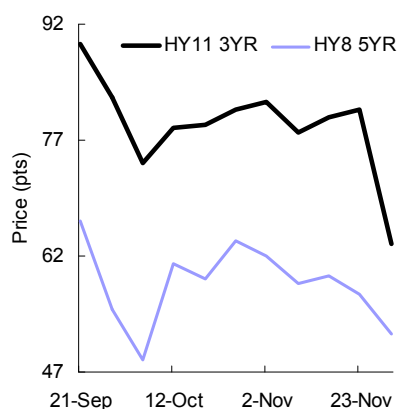
Source: Bloomberg, MarkIt

Options and Tranche Commentary

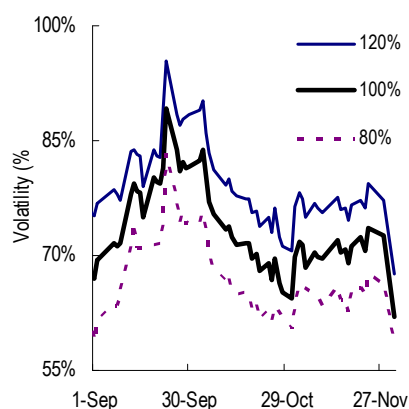
As discussed earlier, the big story in the high yield tranche space was resurrection of default risk. In just one month we saw four high-profile defaults taking place: AMR, Dynegy, MF Global and PMI. The first two credits were actually part of the HY index. In the aftermath, short-dated HY10-15% tranches came under pressure (see left chart). HY11 3yr 10-15% has corrected by more than 20 points. Actually, at current levels (it is trading in the high 80s, ex-AMR and Dynegy), with only 20 days to maturity, in our view, the tranche is worth taking another look.

This week's rally has put pressure on the implied vols, for both CDX IG and S&P. VIX is back to sub-30%, while CDX implied vols are quoted in the mid-60s, the lowest level since August (see right chart). The index skew was flat already and has flattened even more in the rally. The risk-reversal trades, quite popular with investors due to the flat skew, have started to pay-off.

Short-Dated HY 10-15% Tranches



CDX ATM Vol and Skew



Source: CIRA

Short-dated high grade junior risk also underperformed despite news of potential settlement between MBIA and banks which buoyed MBIA spreads.

Delta Adjusted Moves – Selected CDX Tranches

		0-3	3-7	7-10	10-15	15-30	30-100
CDX9	Weekly	-1.79	-0.16	0.03	-0.02	0.01	0.03
5Y	Monthly	-2.60	-0.13	0.09	0.00	0.01	0.02
CDX9	Weekly	-2.20	-0.08	-0.14	-0.31	0.02	0.11
7Y	Monthly	-2.74	0.14	-0.20	-0.46	-0.13	0.18
		0-10	10-15	15-25	25-35	35-100	
HY10	Weekly	0.00	0.12	0.81	0.08	-0.03	
5Y	Monthly	0.00	-4.05	1.72	1.12	0.13	

Source: CIRA

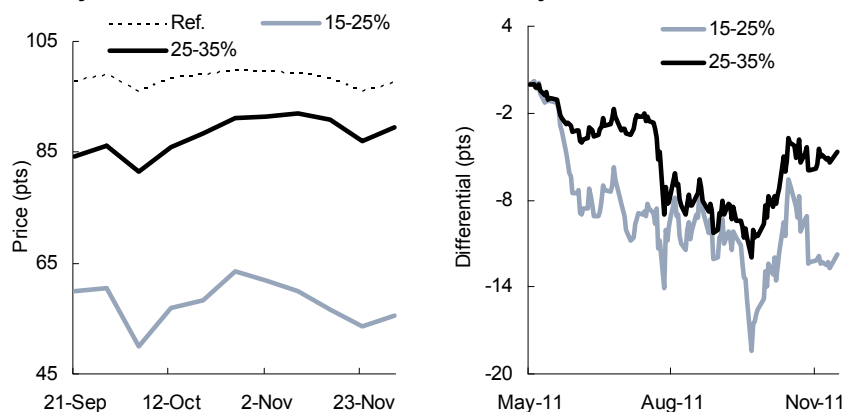
Buy HY10 7yr 15-25% protection versus sell 25-35% in 1:1.5 ratio

As discussed above, we think that post the recent defaults, the market psychology with respect to jump risk is going to change. The market has become accustomed to just 1-2% annual default rate over the last several years, but our base case scenario projects 2-2.5% next year, with a substantial risk of a higher 4.5-5% number, if the European crisis is not contained and we, moreover, see other opportunistic default filings (aka AMR, Dynegy).

We think that an interesting trade to consider is to buy protection on HY10 7yr 15-25% tranche against HY10 7yr 25-35%. We recommend doing this trade either delta-adjusted (1.0 by 1.3) or slightly overweighting delta (1.0 by 1.5-2.0). HY10 10-15% tranche is getting thin (currently just 2.8%) post DYN and AMR. 3-4 defaults with recoveries of 30-40% should completely wipe it out and start eating into 15-25%. More important, with each subsequent default 15-25% tranche should continue underperforming, similar to its behavior this month (see charts below). HY10 7yr index and tranches will mature in 3.5 years; there are a good number of risky credits that are likely to wipe out the 10-15% tranche and start affecting 15-25% directly.

The HY10 7yr 15-25% tranche has been underperforming both senior tranches as well as its delta by a wide margin. Hence this trade would make the most sense to investors concerned about the near-term default risk. Moreover, investors should benefit from a positive rolldown and carry, though they should keep in mind negative convexity of the trade. To partially offset the convexity effect, investors might want to take a view on the market direction. Bullish investors might overweight the trade's delta, while bearish could underweight.

HY10 7yr 15-25% vs. 25-35%: Levels Delta-Adjusted



Source: CIRA

Trade Levels

Tranche	Action	Nominal	Price (mid)	SNAC (mid)	Delta
15-25% 7yr	Buy CDS	10mln	55.3	2400	2.90x
25-35% 7yr	Sell CDS	13mln	89.4	840	2.20x
HY10 7yr			97.5		

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Appendix A-1

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